Final Public Report
Focused Audit of Affiliated Transactions
and Management Audit
of the South Jersey Gas Company

Volume Two: Cost Allocations and Affiliate Relationships

Public Version

(SHADED MATERIALS ARE CONFIDENTIAL)

Presented to the:

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Cost Allocations and Affiliate Relationships
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Note: Shaded information on pages 22 and 23 is proprietary and confidential.

I. Background

This section describes Liberty's approach in examining how SJG has distributed shared costs among itself and its non-utility affiliates, and provides the context for understanding how SJG fits into SJI. This chapter also includes the affiliate transaction-related aspects of Liberty's examination of relationships among SJG and three companies in whom SJI has a part-ownership position (MSI Northeast, Millennium Account Services, and AirLogics).

This chapter excludes potential cross-subsidization of non-utility affiliates through holding-company financial structure or through gas-procurement activities. Separate chapters address those topics. Finally, the portion of Liberty's report addressing SJG's compliance with EDECA requirements addresses a number of other elements of the relationships among SJG and its non-utility affiliates, including but not limited to Millennium Account Services, and AirLogics.

A. Approach

Liberty's examination of cost allocations focused on assessing whether SJG, and by extension, SJI and its subsidiaries, used accounting policies and operating practices sufficient to assure that SJG was not subsidizing the operations of its affiliated non-utility companies. Liberty began by gaining an understanding of the structure of SJI and its subsidiaries, including how they are organized and staffed, and how they account for transfers of services, goods, and assets between themselves. Liberty then examined the policies, procedures, methods, and activities for assuring that the entities involved properly record all such transfers, and price them in a manner that precludes any subsidy by utility operations of non-utility enterprises. Liberty also performed sample tests to assure that the SJI family of companies provided for sufficient control over the authorization, recording, and pricing of affiliate transactions.

B. Summary of Recommendations

CA-1. Comprehensively change the process for developing rates used for hourly billing.

CA-2. Calculate all three-part allocator components on a consistent, 12-month basis.

CA-3. Recalculate the ratios for 2005 by transferring leased assets from the "account" of the affiliate lessor that of to the affiliate lessee.

CA-4. Distribute the tax benefits that SJI realizes from the ESOP and 401(k) plan in a manner that reflects which entities caused the benefit and by how much, and revise SJG's books for 2004 accordingly.

CA-5. Re-calculate and book corrected rent and lease payments due SJG for current and future fiscal years.

CA-6. Recognize which entity is the beneficiary of work done for it and assure that it pays accordingly.

CA-7. Use a competitive-bidding process to find the next provider of meter-shop services.

CA-8. Enter no more relationships in which an SJI company or related company provides utility-type services to SJG.

CA-9. Improve and simplify IS billing through the use new tools available.

CA-10. Assure proper identification of the use of and cost responsibility for Lawson system modules.

CA-11. Revamp and simplify the collection and reporting of inter-company charging.

CA-12. Devote a full-time equivalent person to assuring that the tasks of distributing costs among affiliates are done in a timely manner.

C. Structure of SJG's Affiliates

SJI is a holding company that is exempt under the Public Utility Holding Company Act of 1935. It is a New Jersey corporation. SJI now has six major subsidiaries:

- South Jersey Gas Company *(SJG)*: the local-distribution public-utility company, of which it owns all the outstanding common stock
- South Jersey Resources Group, LLC, *(SJRG)*: started in 1996 and sells natural gas at wholesale and natural-gas related services to utilities and marketers of fuel
- South Jersey Energy Company *(SJE)*: organized in 1973 and sells natural gas and electricity and energy-market services to end-users; *i.e.*, at retail
- SJE also holds SJI's half ownership interest in AirLogics, LLC *(AirLogics)*, a joint venture with GZA GeoEnvironmental, Inc. AirLogics formed in 2000 as a Delaware corporation and providing environmental monitoring devices and services associated primarily with site remediation activities
- South Jersey Energy Service Plus, LLC *(SJESP)*: formed in 2004 as a wholly-owned SJI subsidiary (formerly South Jersey Gas Service Plus, LLC), and providing and servicing gas-using appliances for consumers (prior to August 2004, the SJG operated service portion of the business)
- Marina Energy LLC *(Marina)*: formed in 2000 and developing, owning, and operating projects that supply thermal and electrical energy to large commercial and industrial end-users
- Millennium Account Services, LLC *(Millennium* or *MAS)*: formed in 1999 as a joint venture with Conectiv Solutions, LLC (owned by Pepco Holdings) and providing meter-reading services in southern New Jersey to Atlantic City Electric and SJG, the two largest utilities in the area.

Discontinued SJI businesses comprised a minimal part of the corporation's activities in recent years. SJI's cumulative loss from these operations in the period 1999-2003 was less than $3 million. As will be shown below, the discontinued businesses still receive support from SJI's and SJG's service functions. These businesses include:

- SJI EnerTrade, Inc. and South Jersey Energy Solutions, LLC, which SJE owns
- R&T Group, Inc.
- Energy & Minerals, Inc. (EMI)
- South Jersey Fuel, Inc., which EMI owns.

SJG comprises SJI's largest and most important business unit, in terms of profit contribution, revenues, and assets, as the following three tables show.

Table I-1. Operating Income by Line of Business

Business Line	2003	2002	2001
Gas Utility Operations [SJG]	$65,420	$60,874	$60,463
Wholesale Gas Operations [SJRG]	4,998	4,280	4,628
Retail Gas and Other Ops [SJE, SJGSP]	5,600	4,159	3,824
On-Site Energy Production [Marina]	3,122	416	—
General Corporate [SJI, MAS]	(1,297)	(654)	(371)
Total Operating Income	$77,843	$69,075	$68,544

Millions of Dollars

Table I-2. 2003 Operating Revenues of Active Companies

	SJI	SJG	SJESP	SJE	SJRG	Marina	Eliminations/ Adjustments	Consolidated Total
Utility		528					(40)	488
Non-Utility	2			187	11	13	(5)	209
Total	2	528	806	187	11	13	(45)	697

Millions of Dollars

Table I-3. 2003Assets of Active Companies

SJI	SJG	SJESP	SJE	SJRG	Marina	Eliminations/ Adjustments	Consolidated Total*
329	946	0	60	79	73	(370)	1,126

Millions of dollars; Consolidated total includes $9 million in assets of inactive companies

SJG is also, by far, the largest employer among the SJI companies, as the following table shows.

Table I-4. Employee Distribution

Entity	Employees
SJI	33
SJG	520
SJE	12
SJESP	71
SJRG	5
MAS	6
Marina	2
AirLogics	1
Total	650

As of mid-August 2004

Before SJI spun the appliance-service business off from SJG to SJESP (discussed in detail below), SJG had about 90 percent of SJI's employees. The majority of SJESP's employees, like those of SJG, works in the field or directly supports field employees.

SJG and, more recently, the *On-Site Energy Production* category, as shown in the following table have taken SJI's principal investment in tangible property, plant, and equipment in recent years.

Table I-5. Property Additions

Business Line	2003	2002	2001
Gas Utility Operations	53,238	49,646	47,799
Wholesale Gas Operations	6	--	61
Retail Gas and Other Operations	245	138	163
On-Site Energy Production	8,137	33,925	17,915
Total Property Additions	61,626	83,709	65,938

Thousands of dollars

SJI considers the following to be the products and services of its companies:

South Jersey Industries

- Holding company

South Jersey Gas Company

- Retail gas sales
- Emergency heater-repair service
- Relocating utility facilities
- Other tariff-related services

South Jersey Energy Company

- Retail sales of natural gas and electricity
- Energy services
- South Jersey Energy Service Plus
- Installation of heating and cooling systems
- Appliance service
- Marina Energy
- Development of energy projects
- Management and operation of energy plants

South Jersey Resources Group

- Wholesale sales of natural gas

Millennium Account Services

- Meter-reading services

AirLogics

- Air-monitoring services

SJI identifies the following business relationships between SJG and its non-utility affiliated companies, in addition to the transactions of the type that are governed by SJI's Cost Allocation Manual *(CAM)* that Liberty discusses below.

Table I-6. SJG/Affiliate Relationships

Company	Services
MSI Northeast LLC*	Provides procurement, distribution, sampling, and technical metering services to SJG.
South Jersey Energy Company	Buys natural gas from SJG and uses SJG to bill its customers.
South Jersey Energy Service Plus	Uses SJG to bill customers and take overflow calls and provide after-hours dispatching.
Marina Energy	Uses SJG's tariffed natural-gas transportation services.
South Jersey Resources Group	Buys and sells gas with SJG.
Millennium Account Services	Provides meter-reading and related services to SJG.
AirLogics	Provides air-monitoring services, has leased and purchased equipment.

*SJI has a 4 percent interest in this company.

D. Services Provided among SJI Companies

SJG and its affiliates, like most utilities that operate in a common ownership structure with non-utility affiliated businesses, provide services to each other in the interest of avoiding duplication of work and minimizing costs. SJG and SJI in particular have divided most common serviced functions between them and in a way that generally keeps the functions appropriate to corporate governance at SJI and those that primarily support a utility at SJG. The following chart shows the recent staffing of SJI by cost center. The services element of SJI takes about a third of that entity's employees. The remainder comprises the personnel complement of subsidiaries like SJE and SJESP.

Table I-7. SJI's Employees, by Function

Cost Center	Employees
Executive	3
Financial Planning	5
Accounting	4
Internal Auditing	5
Marketing	4
Shareholder Records	3
Government Relations	1
Sub-total – corporate services	*25*
Total – Non-utility affiliates	*48*
Total – SJI	**73**

As of August 2004

The list below shows the centralized-service functions grouped by the company within which they reside.

SJI-Level Services

- Market Planning & Forecasting
- SJI Accounting
- Risk Management
- Corporate Counsel & Corporate Secretary
- Internal Auditing
- Investor Relations & Finance
- Government Relations
- Strategic & Financial Planning

SJG-Level Services

- Corporate Communications
- Property & Materials Management
- Engineering Services
- Rates & Regulatory Affairs
- Information Systems
- Customer Care Center
- Environmental Affairs
- SJG Accounting & Tax
- Insurance
- Human Resources

During the audit period, these SJI and SJG departments developed service plans, which, although not consistent in detail, provided qualitative and quantitative information about how these functions support the operating business units and other support functions. The following list provides some examples of the information provided in those service plans:

- *SJI Accounting*: supports Marina, AirLogics, several business lines in SJE, SJRG, and SJESP. Also supports other functions in SJI:
    - Financial Planning – budget preparation and updates and *ad hoc* reports
    - Finance – cash-flow projections
    - Shareholder Records – bank reconciliations
    - Environmental Affairs – monthly reports of non-utility environmental spending
    - Internal Audit – financial-records research
- *Risk Management*: supports SJG's off-system sales, Marina, AirLogics, several business lines in SJE, and SJRG.
- *Investor Relations & Finance*: supports senior executives of SJI, and the SJI Accounting and Financial Planning and SJG External Relations and Rates groups, and the non-utility business lines.

- *Internal Auditing*: supports the audit committee of the board of directors, SJI's external auditor and senior management, and SJG, with some small amounts of work for SJE and SJRG.
- *SJI Market Planning and Forecasting*: serves all businesses, but most support is to SJG Utility Sales, SJE, SJESP, and Marina.
- *Strategic & Financial Planning*: supports SJI's executive officers and all business and service lines.
- *Accounting & Tax*: supports Rates & Regulatory Affairs, SJG Distribution Operations, Finance & Investor Relations, Environmental Affairs, Human Resources, Materials Management, and all businesses with payroll and tax services. Also supports non-utility departments.

II. Cost-Allocation Manual

A. Background

SJI's cost-allocation manual *(CAM)* expresses the official statement of the company's policies and procedures on distributing costs among subsidiaries, a reference on the subject for employees, and a repository of information of why particular kinds of costs are distributed in specific ways. Having a CAM that describes how the distribution of costs will take place and enunciates a philosophy of cost distribution that complies with the requirements of regulatory bodies is a necessary condition for compliance, but it is not sufficient by itself. The other element consists of assuring that the results of accounting, documentation, authorization, and pricing decisions and actions made by company employees fully implement the letter and spirit of the CAM, assuming it is correct, and the requirements of a utility's regulators. Much of this chapter addresses Liberty's examination of efforts to provide those assurances in terms of results.

B. Findings

SJI issued its first CAM in December 2001. It has since updated and changed a number of CAM contents. The company has retained a record of the reasons for these changes. SJI reissued the CAM in September 2004. The original and the new CAM have each included more than mere compilations of policies and procedures. They contain copies of memoranda, analyses, and invoices that serve as models, documentation, examples, and instructions on how to distribute costs among affiliated businesses. The new CAM contains an expanded and more-useful introduction and explanation of its contents. SJG has the primary responsibility for maintaining the CAM.

Both the original and updated CAMs have sections addressing the provision of services by SJG to third parties who serve customers and who use SJG's utility-type services to do so. These third parties include affiliated and third-party marketers of energy and energy services; SJESP and its predecessor, SJG's ASB; and SJE. The SJG functions most involved in providing these services include the customer care center and the computer operations unit of the information systems department. The procedures in this CAM section cover services and that SJG charges to others (SJESP, marketers, and SJE) as part of their efforts to bill their customers. Another section provides for charges for administrative time for supporting marketers (direct labor plus the benefits loader, discussed below).

C. Conclusions

a. SJI's CAM is adequate.

SJI's CAM is a thick document, with much detail; it covers many topics with more specificity than other CAMs that Liberty has reviewed. SJI's accountants treat it as a work in progress, which is the correct stance, and which means that while it is not up to date, Liberty did not find that it is so stale as to cause problems.

The CAM shows that SJI has sought to be careful about the details of distributing costs among SJG and its affiliates. Liberty also found numerous instances in which specific types of costs are directly assigned, and not distributed through a broad allocation. This approach avoids over use of a "default" general allocator for distributing administrative and general costs, and promotes consistency between who pays and how reflects how SJI or SJG incurs those costs and who benefits from them.

D. Recommendations

Liberty has no recommendations regarding SJI's CAM.

III. Shared Costs Distribution Methods

A. Billing Rates and Rents

1. Background

Labor and associated benefits generally comprise the largest type of cost distributed among affiliated companies in a holding company. It is commonly accepted that it is preferable to assign to the greatest extent practical labor costs specifically to the department for whom the work is done. Direct billing of hours or of hourly rates generally comprises the method for such direct charging.

An inter-company hourly billing rate should leave the billing company at least no worse off by having lost the benefit of an employee's time spent serving another entity. The same logic applies for billings for the use of capital assets, through leases and rent charges. Meeting this test in the case of labor requires that the employing company secure reimbursement for the employee's direct salary, with adjustments to account for:

- Non-productive time, such as vacation, holiday, and sick time
- Payroll taxes
- Employer costs for benefits, such as pensions and medical and dental coverage.

2. Findings

SJI's CAM describes the hierarchy of preferred methods for distributing costs, and requires employees who provide services to other SJI companies, in addition to the company for whom they work, to record their time in a manner that supports its billing to benefited entities. The CAM also describes how to calculate *loadings*. Loadings apply to the hours, as an additive factor, which assures that benefiting entities bear the costs of payroll taxes and fringe benefits, in addition to the direct cost of salaries. These additional costs include:

- Pay for time not worked (vacation, holiday, sick, and excused absences)
- Legally-required benefits (Social Security taxes, unemployment and workers compensation, and state-required disability)
- Fringe benefits (retirement, medical, long-term disability, life insurance, dental insurance, tuition reimbursement, stock-purchase plans)
- Miscellaneous (stand-by pay, breaks, others).

SJI's approach adds all these costs, and divides the sum by the number of straight-time hours worked in a year by all SJG employees. SJI projected the 2004 value of the sum of all such benefits at $22.1 million. SJI projected the number of working hours for the year for all employees at 1.2 million. The division of these two components produced a rate of $18.37 for SJG. This amount served as the hourly benefits *loader* for hours charged between all SJI subsidiaries for 2004.

SJI has designed this benefits loader to recapture the costs enumerated above from the affiliate that an SJI subsidiary's employees serve. The loader does not accomplish the initial distribution of the costs of the benefits. Instead, SJI, wherever possible, initially distributes those costs (*i.e.*, pension, company participation in the 401(k) plan, health care, dental, and other insurances) by directly assigning them to its subsidiaries on the basis of information about how those costs are being incurred. For example, SJI's actuarial consultant computes the cost of the retirement plan, by subsidiary. Where such an approach is not possible, SJI generally uses the proportional number of employees as the allocation factor. Thus, the employing company initially bears the total costs for such items. It will end up bearing them finally as well, except to the extent that it bills hours, which include the hourly loader, to affiliates for whom its employees do work.

SJI's approach requires the employee's *home company* to bear finally the cost of non-productive time; *i.e.*, SJI does not bill such time or include it, although an estimate of that cost is included in the loading-factor calculation for hours that it does bill. The billing of time by SJG's information systems department stands as an exception to this rule. It uses a group hourly rate (blending the costs of different employee classifications). This rate does include a separate calculation of non-productive time and the previously discussed benefits loader. A following section discusses this rate at greater length.

SJG develops its operating and capital costs for vehicles, and distributes them to users through an hourly rate. These rates have significance for SJESP, which uses SJG vehicles, as its predecessor did before the August 2004 spin-off of the appliance-service business from SJG to SJESP. It has no relevance, however, for other subsidiaries, which obtain vehicles through separate leases. Moreover, the relevance to SJESP is diminishing, because SJESP has been leasing vehicles on its own as it turns in its SJG-leased vehicles.The hourly rate for vehicle use by SJESP includes depreciation on vehicle assets, but does not include a return on the remaining investment in the assets.

3. Conclusions

a. The methods used to compute hourly billing require significant revision.

SJI reasonably distributes initially the cost of employee benefits; it follows the rule that the cost-causers should pay their fair share of the costs they cause. The next step, which re-distributes these costs through the hourly benefits-loading additive factor when an employee of one subsidiary does work for another, does accomplishes the result required by that rule insofar as it includes all costs except for those of the supplemental employee-retirement plan *(SERP)* that applies to SJI's officers only. This loading factor applies to the costs of the employees of any SJI subsidiary when it charges its costs to others. SJI retains the SERP costs of its officers, although by mistake it re-distributed those costs in the past.

It was reasonable for SJI to decide to use a benefits-loading factor as an adder to the direct hourly labor cost of its employees who work for other companies. The factor's application, however, has been too simplistic in that it uses an average for all employees of SJG. As a result, it does not distinguish between high and low salary and wage rates, and thereby fails to account for the different mixes of employees in the various business units that provide services. The SJI benefits factor has a large component for time not worked and for other benefits costs. These costs can vary significantly depending on the pay of the employees involved. Combining the costs of different employees into a single factor produces overcharges for lower-paid employees and undercharges for highly paid ones. The significant magnitude of the loader ($18.37) likely equals or exceeds hourly wages at the lows end of the range. At the high end, the loader may add only insignificantly to direct costs for salary.

b. SJI and SJG have not used fully-allocated costs in transferring costs of housing and leased assets.

Liberty found that SJI has put significant effort into its cost-allocation processes, and has made improvements during the audit period. It has not gone sufficiently far, however, in assuring the comprehensive use of fully-allocated-cost methods to distribute costs among SJI companies. Two main problems remain:

- Leases and rents between companies result from incorrect calculations
- Charges for personnel time and building occupancy do not completely reflect the costs of employment or of providing space to workers.

The company's policy statement on leases and rents is:

> *Utility assets shall not be leased/rented to affiliates for less than the periodic cost incurred by the utility for holding such assets, including consideration of the return on rate base being charged to ratepayers. As such, an interest rate of no less than SJG's rate of return should be used when the utility is leasing/renting assets to affiliates.*

The "interest rate" now charged in rents and leases does not meet this standard, because it fails to recognize that SJG pays income taxes. The component of the charges that compensate SJG for the use of its money must include the effects of federal and New Jersey corporate taxes. SJG has acknowledged that SJG will earn less than its allowed rate of return on the assets it leases if it charges, as it does now, the after-tax rate.

Rental charges to SJG's affiliates for building space suffer a more significant failing; they do not include even an after-tax return on investment. The portion of Liberty's report that addresses EDECA Affiliate Standards discusses another flaw in the method by which SJI calculates the rents that SJG collects from its affiliated tenants.

SJG uses building rent as a proxy for the costs of employee overheads other than benefits. Using this method to charge overheads simplifies the process for charging such costs, by making rent a comprehensive *housing* cost. Such an approach is a reasonable way to simplify the process of distributing and collecting these types of costs. Once that method is chosen, however, it must truly be comprehensive in the costs it includes. SJI currently burdens hourly rates for labor and square-footage rents for building space. It does not include costs for items such as furniture, personal-computing equipment and information-systems charges, vehicle usage, and insurance other than for property.

In addition, users of services from the customer care center and the mailroom should pay for direct time adjusted for nonproductive time, and all of the costs associated with using that labor. The costs should include benefits, rent for office space, vehicles, equipment, office furnishings, supervision, internal services (such as those for information systems), and for all assets used, including a provision for the return of and return on capital.

4. Recommendations

1. Comprehensively change the process for developing rates used for hourly billing.

Liberty and SJI discussed one approach to solving the problem of one benefits loader, which would be to apply different overhead rates for differing classes of employee; *e.g.*, executive, exempt, and non-exempt employees as one classification system, or executive, management, and non-management employees as another classification system. The details of how many categories should be used and their composition are decisions that SJI and SJG accounting personnel should make, in part by considering how much flexibility the Lawson payroll system has in using different overhead rates, and how the system helps in automating the calculations of the components. Liberty understands that the on-line time-sheet feature of the Lawson may not permit the use of multiple benefit rates. If that is the case, then implementation of the solution described here may take significant flexibility. In addition, there should be two different sets of rates, one for SJI and one for SJG.

This solution would constitute an improvement, but would still not accurately charge the actual correctly of personnel time. Any system using category rates creates inaccuracy because it relies upon simplifying assumptions that are necessarily arbitrary. Such a system also requires annual studies. Should the Lawson system create the flexibility and functionality to use the payroll system to charge disaggregated and burdened rates by employee, SJI will be able more precisely to capture the cost of employees' time. The structure of such a disaggregated billing method that should include:

- Hourly straight-time pay divided by average productive time (percent) (or multiplied by a factor less than one that represents estimated productive time)
- A multiplicative factor of average annual payroll taxes, by employee category, divided by productive hours; the use of category rates recognizes that highly-compensated employees are not subject to FICA above a certain level of earnings
- Average cost of fringe benefits (medical, dental, retirement, perquisites, *etc.*), by employee category, divided by productive hours; this factor should, if possible, include a special rider that recognizes any extra benefits that SJI and SJG give to officers
- Estimated *housing* costs (rent, office equipment and furniture, insurances in addition to property, which SJG already includes)
- Vehicles and other capital assets used as part of an employee's normal job function
- Estimated overhead cost of internal services, especially IS charges.

SJI can develop these hourly rates with budgeted figures. Adjustments or true-ups should not prove necessary, absent an extraordinary change in a component compared to its budgeted amount. Following portions of this report address this subject in more detail.

B. The Corporate and Fiscal Expense and Management Service Fee

1. Background

Subsidiaries of utility-holding companies commonly have some categories of costs that cannot be directly assigned or attributed to cost-causative factors. In these situations, costs are accumulated and then distributed among subsidiaries using allocation factors that usually reflect differences in the sizes of the companies.

SJG bills its affiliates directly for the services it provides them, using hourly rates. SJI does the same, but not for all of the work that its employees do, nor for all of the costs it incurs on behalf of its subsidiaries. The difference arises from the corporate-governance and ministerial nature of some SJI functions that benefit all affiliates. SJI uses two methods to distribute the cost of such functions:

- Corporate and Fiscal Expense
- Management Service Fee.

2. Findings

The *Corporate and Fiscal Expense* allocator consists of a cost *pool* that SJI uses to accumulate and distribute costs for corporate governance and financial functions; *e.g.*, investor relations, shareholder records, corporate secretary, external relations, government relations, and professional services. SJI uses the *Corporate and Fiscal Expense* allocator for such departments because of the functions they perform and because they incur certain overhead expenses. The corporation's annual meeting, which cannot be directly charged on a cost-causative basis to benefiting subsidiaries, provides an example of such expenses. All SJI employees fill out time sheets because their costs are likely to be subject to assignment to other companies.

The *Management Service Fee* is a cost pool that SJI uses to accumulate and distribute certain residual or indirect costs that it does not directly charged to subsidiaries, and which comprise some of the regular operating costs of SJI that benefit all affiliates. These indirect costs include:

- Charges to SJI for employee benefits whose costs SJG pays on behalf of all subsidiaries
- Costs of SJG employees who perform services for SJI
- Rent and office supplies (half of the rent is retained by SJI and not further distributed)
- SJI's cost for the fees and expenses of the corporate board of directors
- Costs that SJI receives as the result of other processes for distributing costs; *e.g.*, the *Corporate and Fiscal Expense*
- Cost of the SJI accounting function
- Other miscellaneous costs that cannot be directly attributed to a particular activity; *e.g.*, like the cost of catering meetings of the board of directors.

SJI distributes these two categories of indirect costs (*Management Service Fee* and *Corporate and Fiscal Expense*) to the SJI subsidiaries under what it calls a *three-tiered* (three-part) allocation method. SJI began to make separate allocations to SJG's appliance-service business as of January 1, 2002. SJI calculates the three-part allocation factor by equally weighting the subsidiaries' assets, payroll, and margin. The calculation of the three-factor formula uses actual figures for the middle of the year, *i.e.*, at June 30, so that budgets can be prepared. The new factor takes effect on the following January 1. The following table shows the results of the three most-recent calculations.

Table III-1. Allocation Distribution Using the 3-Factor Formula

Year	Factor	SJI	SJG	ASB	SJESP	SJE	SJRG	Marina	EMI	R&T
2002	Assets	0.8	89.9	0.6	n/a	2.0	1.3	5.3	0.1	0.0
	Payroll	2.5	84.4	7.1	n/a	4.3	1.5	0.2	0.1	0.0
	Margin	0.0	89.6	3.3	n/a	3.6	3.4	0.0	0.0	0.0
	Weighted Avg.	**1.1**	**88.0**	**3.6**	n/a	**3.3**	**2.1**	**1.9**	**0.0**	**0.0**
2003	Assets	2.7	81.4	0.6	0.0	2.5	5.2	7.0	0.4	0.2
	Payroll	3.2	81.0	7.6	2.0	4.0	1.9	0.3	0.1	0.0
	Margin	0.0	85.6	3.7	1.0	5.7	3.0	1.1	0.0	0.0
	Weighted Avg.	**2.0**	**82.7**	**4.0**	**1.0**	**4.1**	**3.4**	**2.8**	**0.2**	**0.1**
2004	Assets	2.6	81.5	n/a	0.6	3.7	3.8	7.2	0.4	0.2
	Payroll	6.9	78.2	n/a	9.6	3.5	1.4	0.4	0.0	0.0
	Margin	0.0	80.7	n/a	4.1	6.5	2.7	6.0	0.0	0.0
	Weighted Avg.	**3.2**	**80.1**	n/a	**4.8**	**4.6**	**2.7**	**4.5**	**0.1**	**0.1**

Figures are percentages; ASB business transferred to SJESP in 2004

SJG's share of the costs distributed by the *Management Service Fee* and *Corporate and Fiscal Expense* has fallen over time, as SJI's non-utility activities have grown. SJG's share fell from 88.0 to 80.1 percent between 2002 and 2004. That trend will continue if the pattern of non-utility growth continues, as SJI currently forecasts it to do. Both recent history and existing plans show higher non-utility growth rates when compared to utility growth.

3. Conclusions

a. The composition and application of the three-factor allocator are reasonable, and the method used for making the calculations needs only minor corrections.

The measures of size that SJI has chosen are fair and similar to those used by other utility holding companies. It is common for this type of allocation factor comprise multiple (often three) parts. Combining factors helps to avoid unfair distribution of common costs because of differences in the structures of business units. The types of costs that SJI distributes under this allocator are typical of those that others generally put in the cost pools to which this allocator is applied. The method of using the average of three measures demonstrates substantial improvement over SJI's past practice of using assets alone as the allocation factor.

Liberty reviewed the workpapers that supported the calculations of the three-part allocation factors for the period 2002 to 2004. Liberty observed that SJI determined the asset-ratio calculation on the net-asset values for each of the business entities from the balance sheet as of June 30 for the corresponding years. SJI made the margin calculation similarly, using the corresponding gross margin for each of the entities from income-statement items for the 12 months ended June 30. The asset and margin calculations therefore showed consistency. The calculation for the payroll factor, however, did not. SJI calculated the 2002 and 2003 payroll component using the six-month period ending on June 30; it calculated the 2004 payroll component by using the full year that ended on June 30, 2004. The 2004 method is preferable, because it is less likely to be skewed by seasonal factors.

Assets owned by one SJI entity but leased to an affiliate remain on the books of the owning entity. The three-factor allocator uses the current asset-ratio calculation, which has the effect of increasing the allocations to the owning entity; *i.e.*, failing to assign any asset value to an affiliate leasing assets. This approach assigns too high a percentage of allocated costs to those entities who lease assets to affiliates. SJI should assign the net book value of leased assets to the business entity using them. Such a change would produce a fairer asset-ratio calculation.

4. Recommendations

2. **Calculate all three-part allocator components on a consistent, 12-month basis.**

3. **Recalculate the ratios for 2005 by transferring leased assets from the "account" of the affiliate lessor that of to the affiliate lessee.**

C. SJG Support Services for SJESP

1. Background

SJG's customer care center *(CCC)* answers overflow calls for SJESP, which has its own separate telephone room in a non-SJI building. The BPU order approving the transfer of SJG's appliance-service business to SJESP did not address this issue. SJG's CCC provides no similar services for other SJI companies or third parties.

SJG also bills SJESP's customers, processes customer payments, and handles some materials-management tasks. SJESP also shares the automated-dispatch system with SJG. Liberty's particular focus was on how SJG charges SJESP for answering overflow calls because it is more than an incidental service held over from when the appliance-service business was part of SJG. The chapter on customer service in this report addresses other aspects of this service to SJESP.

2. Findings

SJG charges SJESP at the average hourly salary rate of the representatives in the CCC, to which it adds the standard benefits loading. The representatives in the CCC track the numbers of calls they take, segmented into two different call types, and the type of representative taking the call (full-time, part-time, auxiliary worker, and commercial clerk). The CCC does not track the actual time for each call taken for SJESP. Multiplying the number of calls times the average length of SJESP calls, developed in a study, produces the billable amount of time. SJG does not charge SJESP for the office space used by CCC representatives, and imposes no other charges for overhead costs; *e.g.*, furniture, computers, and supervision. Liberty also discusses this flaw in SJG's approach in the next section of this report.

CCC's overflow-call work for SJESP comprises only a modest portion of its total activities. For example, the October 2004 the charge for this service for SJESP amounted to the equivalent of 3 full-time people from among the approximately 40 full-time-equivalent CCC employees. SJG renders monthly bills to SJESP for this service and for including SJESP's charges for appliance service in SJG customers' bills.

Liberty found that SJG has generally paid attention to assuring that the appliance-service business pays its fair share of costs and is not cross-subsidized by other operations. Exceptions include the problems of hourly rates and the failure to include SJG's return on investment in leases. Liberty also observed a problem with some costs of the transfer of the business, as discussed elsewhere in this chapter and the chapter on EDECA Affiliate Standards. Examples of attention by SJG to charges for appliance-service business work for SJESP include:

- The application of an overhead factor to the cost of spare parts and the addition of a charge for the carrying cost of inventory (although it is incorrectly computed because it uses SJG's after-tax cost of capital)
- Tracking separately the depreciation expense of dispatch system communications and computer equipment that SJG uses both for its own field technicians and for appliance-service work
- Tracking and charging the distinct cost of data-entry and computer time for the use of the payroll system by the appliance service business and by other business units.

The portion of this report addressing charges from the information systems department discusses the last two items in detail.

3. Conclusions

a. SJG has been has been attentive to assuring that the appliance-service business appropriately bears support costs.

4. Recommendations

Liberty has recommendations on related topics concerning SJESP below.

D. Assignment of ESOP Tax Savings

1. Background

SJI's CAM contains a section addressing federal and New Jersey tax expenses and payments. This section incorporates SJI's policy and procedure on the preparation of federal and state income-tax returns. The policy states that SJI will compute each subsidiary's tax obligation on a standalone basis. SJI then incorporates individual results into SJI's consolidated returns. The CAM section and policy on tax returns does not cover the topic of the ESOP benefit, but does sate that, "There is no allocation of a consolidated tax benefits [sic]."

Utility holding companies generally *push down* their tax benefits to their subsidiaries. In a similar manner, they distribute other costs to their subsidiaries. For example, SJG bears its ratable share of the cost of functions such as shareholder records, as it should, even though shareholders own stock in SJI, not SJG.

2. Findings

SJI has realized tax benefits from its employee-stock-ownership plan *(ESOP)*. The parent has retained all those benefits at the holding company level; SJI has not distributed or pushed any of them down to SJG or other subsidiaries. SJI's rationale for retaining the ESOP tax benefits is that they are "calculated on SJI common shares and the SJI dividend payment is not a direct function of any subsidiary dividend payment to SJI."

SJI budgeted its New Jersey Corporation Business Tax and federal-income tax ESOP benefits for 2004 at $189 thousand and $670 thousand, respectively, for a total of $985 thousand. SJI should distribute this tax benefit to its subsidiaries using an allocation factor that reflects the relative contribution of each subsidiary to the ESOP benefit. SJI should determine the amounts as part of its tax accounting. Pending such an analysis, Liberty used common equity as a proxy that would give some indication of the value of this benefit to SJG. End-of-year 2003 values for common equity would yield an allocation percentage of 92 percent for SJG, or $902 thousand for that year alone. Liberty does not know what benefits will accrue in the future from the ESOP, and understands that SJI terminated that plan as of October 1, 2003. The 401(k) plan will continue, however, and will provide tax benefits. The tax benefits that SJI enjoys from the 401(k) program should also be shared with SJG in a manner that recognizes its contribution to their existence.

3. Conclusions

a. SJI erred in not sharing tax benefits with its subsidiaries.

4. Recommendations

4. **Distribute the tax benefits that SJI realizes from the ESOP and 401(k) plan in a manner that reflects which entities caused the benefit and by how much, and revise SJG's books for 2004 accordingly.**

E. SJG's Leases with SJESP

1. Background

South Jersey Energy Service Plus (*SJES*) took over what formerly comprised SJG's appliance-service business (*ASB*). The BPU approved on July 29, 2004 SJG's request to transfer its ASB from its utility operations to a non-utility affiliated company (Docket No. GM02080609). SJESP before that time had performed heating and cooling installations.

The BPU order approving the transfer required SJG to submit a compliance filing. The compliance filing included final versions of an *Administrative Services Agreement* between SJG and South Jersey Energy Service Plus, LLC, effective September 1, 2004. This agreement lists 24 services that SJG will provide for a period of one year or longer if renewed. The agreement provides for billing for services at rates described in SJI's CAM. The services covered by the agreement include traditional general and administrative services, as well as billing and collection and overflow customer-service support services.

The transfer of the business from SJG to SJESP included leases whose payments total $198 thousand annually:

- A sale of equipment (consisting almost entirely of appliance-repair spare parts)
- A lease of equipment (covering air-conditioning repair tools, the automated-dispatch computer system and its associated communications equipment, and vehicles)
- Leased premises.

2. Findings

The components of the lease payments include the traditional ratemaking items consisting of return of, and return on, plant assets; *i.e.*, the annual depreciation of the equipment and a return on the net book value of the assets. The calculations for these leases, however, use an after-tax rate of return, not the pre-tax return, or *grossed-up*, value. The return portion of the annual lease cost is $49.4 thousand; calculating it properly on a pre-tax basis would produce $81.5 thousand, or an additional $32 thousand per year to SJG from SJESP.

The premise-lease agreement has the same term as the Administrative Services Agreement, and covers a total of 2,650 square feet, 2,242 square feet of which SJG's Glassboro facility contains. The total annual rent payment is $32 thousand; the rent for the use of the space in Glassboro is $25 thousand. The portion of Liberty's report addressing EDECA Affiliate Standards describes how SJI incorrectly excludes a return on, and return of, investment in calculating the rents charged by SJG to affiliated companies. The omission applies here also.

A Stipulation in the docket addressing the transfer of the appliance-service business provides that:

> *invoices for these [administrative] services will be in a form which will be easily accessible by the Staff of the Board of Public Utilities, in order to ensure compliance with appropriate cost allocation.*

SJI/SJG were able to produce invoices readily. The invoices, however, did not contain sufficient support for the invoiced amounts, which this report addresses in Chapter IV.

3. Conclusions

a. The rates for all leases and rents are too low.

All lease or rent payments between SJI subsidiaries should include a return of, and return on, capital provided by the leasing affiliate. The lease or rental costs should include the book depreciation expense (return of capital) and SJG's *pre*-tax allowed return on equity, not its after-tax return. Liberty notes that the leases to SJESP did come before the BPU as part of the transfer of the appliance-service business. Liberty also addresses this issue in a section above on rents and leases.

The need for adjustment to return calculations applies to the equipment that SJG has leased to SJESP and to the other rents that SJG charges its affiliates for the use of space in the buildings that SJG owns. It also applies to other assets that SJG buys and makes available to other SJI companies, including IS equipment and software; *e.g.*, the Lawson software, as well as any vehicles that SJG owns and makes available to an affiliate directly or indirectly.

4. Recommendations

5. Re-calculate and book corrected rent and lease payments due SJG for current and future fiscal years.

F. Costs of the Transfer of ASB to SJESP

1. Background

SJG's vice president, rates & regulatory affairs, submitted an August 2002 petition to the BPU to approve a transfer of SJG's appliance-service business to a new company, which eventually became SJESP. In summary, the petition, in what became Docket No. GM02080609, stated that the business was a competitive one, and that as part of a utility it was hampered in competing effectively. As noted above in this chapter, SJG's request for this transfer was later approved by the BPU. A consequence of this transfer was that SJI now owns the same business but in a different way; *i.e.*, it is now a non-utility operation, and the profits it produces will not offset the costs of providing utility service.

2. Findings

Liberty asked SJG for information on how SJI and SJG recorded costs associated with pursuing the BPU application and the business transfer, and which affiliates bore the costs. Liberty examined how the time of persons involved in the transfer; *i.e.*, the vice president, rates & regulatory affairs and his group, SJI/SJG's CFO, SJI/SJG's corporate counsel, and the general manager of the appliance-service business (after the transfer), was charged while the issue was pending, and also how the charges from SJI/SJG's outside regulatory counsel were booked.

Liberty found that SJI/SJG's accounting for the time of a number of resources dedicated to the transfer did not match who would ultimately be benefiting from the transfer. All of the costs were assigned to SJG:

- The time of SJG's vice president, rates & regulatory affairs, was charged effectively 100 percent to SJG during the period of 2002 through August 2004. The time of his principal deputy, the manager, regulatory affairs, was assigned only to SJG.
- During the same period a total of 6 hours of the time of SJI/SJG's CFO was charged to the appliance-service business.
- The corporate counsel's total charges to the appliance-service business during this period amounted to 10 hours.
- The time of the general manager was charged only to the appliance-service business.
- The cost of law firm involved in the docket was charged to SJG's regulatory-expense account.

It is not likely that two key decision-makers (the CFO and corporate counsel) spent virtually no time on this matter during a period of two years. Some of the costs of the two primary regulatory officials should have been assigned to this case. The proceeding did involve a regulatory matter, but one that was aimed at benefiting non-utility operations, not the utility business and its customers. The accounting for these costs therefore appears to be inappropriate, with the exception of the general manager.

The distortion that this mistake causes in SJG's books cannot be remedied because there is no time-sheet data that shows the work that these executives, and possibly other people in SJG, such as Information Systems and operations people who made the transfer possible, applied to this matter. This means that re-charging the costs, except for the outside legal bills, is not possible.

3. Conclusions

a. SJG incorrectly retained the costs of pursuing a transaction that significantly benefited shareholders.

Whenever SJG Regulatory does work that involves current or prospective non-utility services or subsidiaries, its costs (internal labor plus other resources) should be borne by SJI or an SJI non-utility subsidiary. This applies also, more generally, to any SJG employees who help in such dealings.

4. Recommendations

6. Recognize which entity is the beneficiary of work done for it and assure that it pays accordingly.

SJI and SJG need to be more vigilant in identifying the company or companies who derive primary benefit from activities that involve SJG. Employees of both SJG and SJI should be made aware of who and how the work they do benefits non-utility affiliates of SJG when those circumstances arise. SJG should, as a matter of course, set up distinctive matters or ongoing activities as projects with account codes to capture and report labor and other costs and charge them to the company who caused the costs to be incurred.

G. MSI Northeast LLC, MAS, and AirLogics

1. Background

Measurement Solutions International - Northeast LLC *(MSI Northeast)* is a joint venture between SJI and Measurement Solutions International, which was, until recently, a joint venture of Invensys Measurement Services and BC Gas. Invensys is no longer involved. The purpose of MSI Northeast is to:

> *provide a full range of metering and measurement services to utilities and energy service providers in the northeast United States … including procurement, warehousing and distribution of meters, meter sampling, meter population management and maintenance, engineering, and technical support.*

The relationship between Millennium Account Services (MAS) and SJG has been discussed at length in previous EDECA audit reports on SJG and Atlantic City Electric.

Liberty's chapter on EDECA Affiliate Standards describes the relations and transactions between AirLogics and SJG.

2. Findings

SJG and MSI Northeast entered into a five-year service agreement on March 7, 2001. The agreement provides that MSI Northeast will be responsible for buying, managing, monitoring, and maintaining SJG's gas meters, regulators, and gas-volume indicators. To be more specific, this means that MSI Northeast provides the following services in the nature of an SJG contractor:

- Asset management
- Receiving, inspecting, and testing new and used gas meters and associated equipment
- Repairing, re-verifying, and remanufacturing used gas meters and associated equipment
- Coordinating the delivery and receipt of the equipment
- Disposing of any equipment that cannot be repaired
- Delivering the equipment to SJG's facilities
- Keeping records of equipment and repairs
- Meter sampling and analysis
- Identifying and assigning priorities to removing and replacing meters using statistical sampling
- Procurement and logistics
- Buying, storing, and distributing all such equipment
- Developing a meter-sampling plan
- Developing a plan that has policies and procedures for testing meters, sorted by area, with recommendations for changing the groupings by area
- Developing a district management plan
- Developing a plan that has policies and procedures for identifying which meters and associated equipment should be tested, replaced, and discarded, sorted by SJG's districts.

SJG pays MSI Northeast a monthly fee for the meter sampling and analysis service, which the following table shows. SJG also reimburses actual costs incurred by MSI Northeast LLC for reconditioning meters (repairing and remanufacturing used meters, including pick-up and delivery), with expected annual amounts also shown in the following table. SJG also reimburses MSI Northeast for procurement expenses, including the actual costs of equipment and taxes and shipping to MSI Northeast's facility.

Table III-2. SJG Payments to MSI Northeast

Contract Year	1	2	3	4	5
Monthly Service Fee ($)					
Annual Costs ($)					

The parties also signed an operating agreement for MSI Northeast on March 7, 2001. The parties were Measurement Solutions International and SJI. The agreement calls for the MSI Northeast to provide services in the measurement of energy and water consumption, including the provision of: measurement-system support services, measurement-system management, system support, life-cycle management, testing and evaluation of new equipment, use of automated-meter-reading equipment and associated data-management equipment to process information, testing and calibration, and asset management and logistics. The press release that announced the formation of the LLC called it a joint venture; however, the operating agreement says that it is neither a partnership nor joint venture.

SJG's analysis of the financial advantage of outsourcing its meter shop to MSI Northeast showed that over the 5-year period 2000-2004 SJG would save $93 thousand. SJG also believed that other benefits from the plan included:

- The prospect that SJI would receive dividends of $826 thousand
- Avoiding investment of $500 thousand in new meter-shop equipment
- Avoiding the need for new supervision for the meter shop (valued at $320 thousand)
- Having access to a modern meter facility and meter experts and freeing some space for other use.

The total expense and capital that the analysis identified for running the meter shop under SJG's ownership and management over the same 5-year period was $23 million, more than half of which was for new meters and regulators and associated field services. The savings that SJG projected were to come from reduced costs of field services and labor and spare parts in the meter shop, which were mostly offset by charges from MSI. SJG's actual payments to MSI for the calendar years 2002-2004 were [redacted], respectively.

The operating agreement divides ownership interests in MSI Northeast, an LLC, into Class A and B shares, which are owned by Measurement Solutions International and SJI, respectively. At the start of MSI Northeast, MSI owned 96 Class A shares and SJI owned 4 Class B shares; from a financial standpoint, therefore, SJI owns 4 percent of MSI Northeast. The owner of the Class A shares has virtually all of the management power of the LLC, because only Class A shares have voting rights. SJI made an initial capital contribution of $40 thousand in cash to the LLC. The agreement shows an MSI capital contribution of $960 thousand. SJI carries its investment in MSI on its books at a value of $40 thousand.

The cash flow from the LLC is divided among the participants according to their percentage-ownership interests. The operating agreement has an incentive program that gives SJI the opportunity to earn additional Class B shares if it signs up other utilities for the services of the company. The agreement shows a hypothetical calculation in which SJI signs-up two utilities for multi-year agreements. If it got 1.5 million meter-years in agreements it would earn three additional Class B shares. SJI received total dividends of $11 thousand from the venture through 2004.

When SJG completed the outsourcing, the space that the meter shop had previously occupied was leased by SJG to SJESP and made available to SJG's training department. SJG also seconded three employees to MSI Northeast when it took over the meter-shop responsibilities. Two of them returned to SJG within a few months and one retired and was hired by MSI Northeast. SJG charged MSI Northeast for the salary and benefits of those employees while they were at MSI Northeast, but still on the SJG payroll.

The outsourcing also included the sale of the equipment in the meter shop to MSI Northeast for $14 thousand. The original cost of the equipment sold, much of which was old, was $119 thousand. SJG considered the sale of the equipment a *retirement* for accounting purposes.

SJG has done no substantive after-the-fact analysis of the savings realized from the MSI contract. In September 2002, however, a year after MSI took over the meter shop function, the internal-audit department conducted an audit to ascertain whether SJG was still recognizing savings from the outsourcing and enjoying the same level of service. The audit report noted that the main reason that SJG decided to outsource the functions of the meter shop was the cost of upgrading the equipment and personnel. The internal auditors concluded that the outsourcing "… appear[s] to be cost effective …there are several issues that are in the process of being worked out, but nothing that significantly impacts SJG service levels." The outsourcing did achieve the objectives of reducing SJG's payroll and avoiding the need to invest in new meter/regulator test equipment.

MAS is not a separate subsidiary of SJI. The parent company holds SJI's 50-percent investment in MAS, and accounts for it using the equity method. MAS, unlike SJI's subsidiaries, does not directly receive charges through the *Management Service Fee* and *Corporate and Fiscal Expense* allocation factors. Indirectly, however, MAS does figure in the calculation of the three-part allocator. Specifically, SJI's ownership interest in MAS has the effect of increasing SJI's assets in performing that calculation.

SJI provides no services for MAS. Two SJG executives, however, perform Millennium work, for which charges are made. In addition, SJG's human-resources department procures benefits for MAS. MAS continues to use one SJG employee; SJG charges MAS for his time and benefits.

3. Conclusions

a. SJI's and SJG's deal with MSI Northeast LLC raises questions about the propriety of the decision to outsource a significant utility function.

SJI's outsourcing of its meter shop may have been a prudent decision; the issue here, however, concerns the way that the parties structured the deal. The deal appears to have been structured to leave SJG no worse off than would have been the case had it continued to perform the function internally. Had this been a traditional contract, this goal, prudently pursued, may have been sufficient. It is, however, troubling that the deal specifically included the potential for significant gain for SJI; *i.e.*, gain far overtaking the risk that SJI took in investing the small sum of $40,000. That aspect of the arrangement brings in to question SJG's objectivity in pursuing the outsourcing. It, not SJI, made the significant concessions. It also left for SJI an opportunity that, if it had value, should have been captured by SJG, perhaps in the form of lower service costs.

The small capital outlay made by SJI makes it clear that the service provider did not need capital or risk-sharing to make its entry into the agreements good business decisions. It is by no means clear why the service provider would not have been equally happy to give SJG a somewhat lower price, in lieu of taking on SJG's parent as a business partner.

SJI's quantification of the projected benefit was small compared to the projected expenditures that were to be made. This means that the margin for error was small. The result is that it leaves the impression that SJI was willing to put SJG's operation at some risk for the prospect of an earnings boost for SJI.

SJI/SJG made this decision without putting the contract out for bid. Absent a process of soliciting proposals, whatever method was used to determine the pricing basis between SJG and MSI Northeast is open to question, much as was the case with the creation of Millennium Account Services. A deal of this size should have been negotiated at arms-length.

Finally, the joint venture got the meter-shop assets at what appears to be a negotiated value. Instead, in an arms-length transaction with bidding for the business, SJG would have been able to sell the assets at something like their fair-market value, which might have been substantially higher.

Liberty has no conclusions in this chapter regarding MAS and AirLogics.

4. Recommendations

7. Use a competitive-bidding process to find the next provider of meter-shop services.

The current arrangement with MSI Northeast ends March 7, 2006. SJG should immediately start to develop a request for bids for the provision of the same services that MSI now provides to SJG, and should start canvassing prospective providers. There is precedent for this course of action, as SJG recently agreed to put its contract with MAS for meter reading out to bid when it expires.

In evaluating which service provider is best, one alternative that SJG must consider is re-building its in-house meter-shop capability. It seems unlikely that this would be the best option because SJG sold all of its equipment and lost its expertise. SJG should consider the option nevertheless, and with some creativity, it may prove realistic. As part of that analysis, and as an option for bidding third parties, SJG could make meter-shop facilities available to a new operator. In so doing, it might reduce the risk perceived by other bidders.

SJG should also start negotiations with MSI to buy its operations or some of its assets, and should allow bidders to submit proposals to take over those assets if MSI will sell them. In addition, SJG should start negotiations with MSI to extend the contract on a month-to-month basis to assure that it has enough time to find other qualified and interested bidders.

8. Enter no more relationships in which an SJI company or related company provides utility-type services to SJG.

SJG's deals with Millennium, AirLogics, and MSI all permitted SJI to take advantage of its control of the utility to create or advance non-utility businesses. The Millennium, MSI, and *AirLogics* deals may have left SJG slightly better off than the situation before these arrangements, but all were done without considering the alternative of doing business with an unrelated third party either to provide the same service or acquire the same properties under terms more favorable to the utility. It is not correct for SJI to judge potential opportunities as appropriate simply because they leave the utility no worse off, or even somewhat improved. If SJG has an asset of an opportunity arising from its utility assets or operations, it should maximize that opportunity from the utility perspective, not from the combined utility/parent perspective, thereby allowing the parent to capture a portion of the value that should go entirely to the utility. The appearance of self-dealing can not be avoided when the parent takes an economic position in arrangements like those at issue here. That appearance should raise substantial questions about the propriety of these arrangements – questions that should have the benefit of BPU review before commitments about utility operations and assets are made.

SJG should not without prior BPU approval outsource any other functions being performed by SJG to a company in which it has a financial interest (like MAS and MSI). SJG should also not make any transfers of utility assets or opportunities, as it did in the case of AirLogics, to an entity in which the parent or an affiliate has an interest, without such prior approval.

If SJG decides that it has no alternative but to strongly consider future arrangements like these it should only do so after duly considering using the services of other providers. If SJG must do any additional outsourcing deals with a related party, then it should fully consider the economic effects of the transaction, including valuing any asset transfers at market value, and taking into account the value of the intellectual property associated with the assets or going concern.

H. Distribution of Audit Fees

1. Background

As a holding company with subsidiaries in disparate businesses, SJI expends significant sums for independent accountants. Liberty examined the method for distributing the fees charged by these accountants auditor in order to assure no cross-subsidization by the largest business unit, SJG, of the other units.

2. Findings

In general, SJI does not distribute the fees charged by the independent accountants using an allocation factor. Instead, SJI uses budget figures for each subsidiary (supplied by the independent accounting firm) as the basis for directly assigning charges to each affiliate. The firm renders separate bills that are paid directly. Work associated with the 10-Q constitutes an exception to this method. SJI receives a separate bill for such work, and divides its costs evenly between SJG and SJI because there are two 10-Ks. In addition, SJI distributes the cost of work done to comply with the requirements of the Sarbanes-Oxley Act under the three-part allocator.

Annual audit fees have increased every year recently, as have the charges to the non-utility affiliates, as the following table shows.

Table III-3. Distribution of Audit Fees

Entity	2004	2003	2002
SJI	87	83	79
SJG	119	115	112
E & M	3	3	3
SJE	23	17	11
SJ Fuel	2	2	2
SJRG	40	35	30
Marina	18	15	4
Total	292	270	241

Thousands of dollars; 2004 amounts estimated

3. Conclusions

a. SJI properly distributes the costs of its independent accountants.

4. Recommendations

Liberty has no recommendations in this area.

I. Charges from SJG's IS Department to Others

1. Background

SJG's information systems *(IS)* department does work for SJG, its largest customer, and to a considerably smaller extent, for other SJI companies. The other subsidiaries, with the exceptions of SJE and SJESP, require significantly lesser support from IS. For example, the partner in Marina's business performs most of that business's information-technology work. SJRG, based in Texas, uses a local contractor to maintain its trading system. The portion of Liberty's audit report addressing support functions describes the organization and functions of the IS department in detail. IS captures and bills the time of its employees when they do support and project work for SJG and other SJI subsidiaries because there is enough of that work for SJI, SJESP, and SJE to justify the effort.

2. Findings

The use of IS resources by the SJI corporate functions and the SJI non-utility businesses varies considerably. SJG, until the spin-off of the appliance-service business, employed about 90 percent of SJI's personnel, which is a rough indicator of need for IS services. It nevertheless remains appropriate that IS, as the largest SJG function serving other business units, assure that its costs are distributed to non-SJG companies when it provides them with services.

IS operates differently from other internal-service providers in that it uses average departmental hourly billing rates to distribute labor costs to SJG's affiliates when it does work for them. IS also differs from other the other SJI providers of centralized services because it relies on capital assets; *i.e.*, computers, peripheral equipment, communications equipment, and software, to provide its services. It must include asset related costs to assure that the entities it benefits pay the full costs of services that IS provides to them.

SJI's CAM includes several procedures that provide for the processes for distributing IS costs that support supporting operations other than SJG's utility business:

- Charges for use of the automated dispatch system (*ADS*) and associated radio equipment; the basis for these charges is an annual study of the costs of the system (license, maintenance, lease of radio tower) and the extent to which the appliance-service business uses it (developed as the number of vehicles used by ASB/SJESP technicians compared to the total of ADS-equipped vehicles). The ASB vehicles are 32 percent of the ADS-equipped fleet.
- Cellular telephones: charged directly to users' companies.
- Landline-communications services: charged as part of the office-space (building-rent) process, except for actual usage, which is charged to users' departments.
- Use of the mainframe computer, on which the ADS runs, charged to the appliance-service business (now SJESP) for its ratable use of the machine, determined by analyzing the processing time devoted to ADS (10.8 percent) and applying that usage to the total cost of running the mainframe, which is mostly labor cost.
- The cost of SJG's new Lawson financial system. The basis for distributing the maintenance fee and annualized installation costs in 2004 for the modules that benefit companies other than SJG (payroll and human-resources systems) is the number of employees. This method distributes 80 percent of the annualized cost of those systems to SJG, with the remainder is distributed to the other companies based on their headcount.
- Support for personal computers: a third-party service contract is charged out on a per-unit basis, and internal support is billed at an hourly rate by the IS department (as described in the next item).
- Support by IS personnel is billed out at an hourly rate to other SJI subsidiaries and third parties (gas marketers); a new rate is developed annually by:
    - Computing the cost of all labor of each of the three departments in IS, divided by the total number of available hours
    - Adding the SJG hourly fringe-benefit rate computed by SJG's accounting function.

The following table shows the billing rates for personnel from the Information Services and Management Systems divisions in Information Systems for the last three years.

Table III-4.
Hourly IS/MS Billing Rates

	Info. Systems	Mgmt. Systems
2002	$64	$50
2003	66	50
2004	81	67

The third department, Computer Operations, operates and supports SJG's mainframe computer, performs keypunch/data entry services, and handles mail. This group has billed its services according to the rate schedules shown in the following table. The hourly labor rates for 2004 increased because the fringe-benefit rate changed from incremental to fully-loaded.

Table III-5. Computer Operations Charges

	Mainframe Batch Processing	Data Entry	Mainframe Transactions	Mailroom
2002	123	30	0.0273	48
2003	117	30	0.0200	57
2004	133	32	0.0250	65

Rates are per hour except for mainframe transactions, which are per transaction

IS personnel keep track of the time they spend on defined projects and on project and incidental work that they do for non-SJG users. This time is accumulated by managers, and billed out under a monthly invoice of inter-company charges that is distributed to several senior management personnel. The bill shows the charges (hours and dollars) for each work request (work requests are issued for identified projects) outstanding. An attachment to the invoice shows the following detail of all work performed, by subsidiary:

- Date on which work was performed
- IS employee who did the work
- Description of the work
- Total hours for the month and the associated dollar cost.

During the two years of the audit period the IS management systems and information systems groups used the billing rates shown above to charge these other subsidiaries for the following amounts of support work shown in the following table.

Table III-6. Hours Billed to Affiliates

SJE	MAS	SJI	SJESP ASB	SJRG	ASB	Total
269	357	191	110	11	475	1,412

The management systems and information systems groups also billed 1,022 hours to work requests (projects) during the two years of the audit period. The following table demonstrates that two lines of business accounted for most of the billings for Computer Operations services recently.

Table III-7. Computer Operations Charges by Affiliate

Year	ASB	SJE	Other	Total
2002	$23	$2	$8	$33
2003	26	3	7	36
2004 through August	20	3	5	28
TOTAL	$69	$8	$20	$97

Thousands of dollars

The following table shows that there have been modest IS billings to marketers during the audit period (for this purpose, the same period used for the EDECA examination covered in a separate volume). SJG does not true-up its hourly rates, which are based on budgeted estimates. It will adjust them on occasion, however, if there is a significant change in a cost factor.

Table III-8. IS Billings to Marketers

All Marketers as a Group	42
South Jersey Energy	165
Individual Marketers	4.5

3. Conclusions

a. The IS billing processes captures the most important costs, but is still not comprehensive, and relies too much on manual processes.

SJG has processes for billing other SJI companies and third parties for IS services. The billing rates include direct labor, the cost of non-productive time, employee benefits, and it measures of the cost of using IS equipment. IS does not, however, charge its customers for its rent, insurance other than property, and return on the assets it uses. Only in 2005 did SJG begin to have the capability for capturing and reporting most of these costs by department or cost center.

The new general-ledger and project- and activity-accounting modules of the Lawson financial system, along with the established Lawson capability for on-line entry of employee time, will give SJG the ability to capture cost information and then bill it in an automated way

These advances indicate potential for eliminating blended hourly rates. Instead, a more complete and accurate billing basis to account for computer equipment, and other IS-specific costs, along with the new benefits factor(s) and better rental charges described in this chapter, could be used.

SJI has expressed to Liberty the concern that hourly rates reflecting individual, rather than blended, IS employee salaries reduces the predictability of costs for beneficiaries, who will not know in advance who will be doing their work. It is also true that using different rates for every employee risks the disclosure of confidential salary information. These considerations would justify the use of a series of rate categories grouping employees with generally comparable costs, should that be SJG’s preference.

Introducing the Lawson system created an additional need for SJG Accounting, which needs to determine carefully and regularly which units use Lawson modules directly or and indirectly. There need to be assurances that the distribution of Lawson-related charges is correct. For example, the materials-management function appears to use some Lawson modules on behalf of SJESP, but SJESP is not subject to charges for that use. This need will become more significant in the future as more Lawson modules are installed and as their use becomes more widespread.

4. Recommendations

9. Improve and simplify IS billing through the use new tools available.

10. Assure proper identification of the use of and cost responsibility for Lawson system modules.

IV. Testing of Cost Distributions

A. Background

SJI distributes its costs and costs that it incurs on behalf of its subsidiaries by direct billing of the time of its employees (sometimes referred to as *Management Cost Allocation*) and assignable expenses, and through allocations of the two pools of joint costs, the *Corporate and Fiscal Expense* and *Management Service Fee*, which it distributes under the three-part allocation factor. SJI bills its subsidiaries monthly for all of these costs. The billing of employee costs and direct expenses occurs as those costs are incurred.

SJI develops annual budgets for the six cost centers that make up the *Corporate and Fiscal Expense* figure, and accrues and books this amount at the beginning of the year on SJI's balance sheet. SJI then charges out the annual total ratably over 12 months. SJI then trues-up the charges at the end of the year to conform budgeted to actual expenditures, making a manual adjustment if needed. SJI charges actual amounts for the *Management Service Fee* portion as part of its monthly closing.

The following chart shows the relative size in 2004 of each of the three types of costs that SJI redistributes to its subsidiaries and itself.

Table IV-1. Budgeted Distribution of Operating Expenses and Depreciation

Cost Type	SJG	SJESP	SJE	SJRG	Marina	Other	Total
Total SJI direct expenses							7,275.7
SJG labor/benefits allocated to SJI							914.2
Total to be allocated							8,189.9
Distributed by Mgt. Service Fee	(1,844.0)	(88.3)	(90.5)	(75.1)	(61.8)		(2,159.7)
Distributed by Corp. and Fisc. Exp.	(902.7)	(43.2)	(44.3)	(36.8)	(30.6)		(1,057.6)
Assigned by time-reporting process	(1,44.1)	(201.7)	(2,184.2)	(129.7)	(216.0)	(16.4)	(4,192.1)
Allocation of other costs			(85.2)				(85.2)
Total distributed	(4,190.8)	(333.2)	(2,404.2)	(241.6)	(308.4)	(16.4)	(7,494.6)
Retained by SJI							695.3

Thousands of dollars; *Other* category includes discontinued operations

Reviewing billings in dollars by category does provide some indication of how SJI's and SJG's management personnel distribute their time to affiliates; however, Liberty found it necessary to disaggregate the information in order to conducts its examination. Liberty's approach was to take disaggregated data that SJI had made available; *e.g.*, billed hours by employee, by month, and combine it ways that would be more useful for audit-work purposes.

Liberty then applied its judgment about the distribution of employee hours to the affiliates, in order to draw make observations about the overall reasonableness of the distributions noted. Liberty could not, of course, draw definitive conclusions because to do so would require watching employees in the past as they did their work. Nonetheless, there is value in such analysis, given that other audit work gives Liberty a frame of reference for understanding what various work groups do for affiliates, and therefore, at least a general sense of the kinds of activities and beneficiaries to which costs should be assigned.

B. Findings

To the extent that the actual experience follows the budget, about half of SJI's annual total costs are to be redistributed to subsidiaries using time reporting and direct assignment instead of the three-part allocator. What the total figures mask, however, is that SJI's 2004 budgeted payroll includes the payroll for SJE and Marina. This means that more than half of the budgeted direct time is for SJE and Marina employees, and, to a far-smaller extent, other SJI employees who spend some of their time on SJE and Marina work. The effect of this latter phenomenon is observable in the distribution of SJI costs to SJG; *i.e.*, the direct assignment of time by SJI employees represents one-third of that expected total. In summary, while it appears that SJI distributes a particularly large portion of its time by direct assignment, that is in major part true only because some of its employees are in essence fully employed by Marina and SJE.

To understand how SJI and SJG had been distributing costs to each other and other SJI companies Liberty asked SJG for documents that would illustrate its analyses showing the appropriateness of allocations during the October 2002 through September 2004 audit period. SJG's responded by providing a set of spreadsheets—essentially, raw data—that showed intra-company charges from SJI and SJG to SJG, SJESP, SJE, Marina, SJRG, EMI, SJF, and R&T. The response did not include Millennium Account Services, which SJI does not consider to be a related competitive business segment of a gas public-utility-holding company.

In the absence of the kinds of analyses that Liberty expected to see, Liberty prepare the following table summarizing the data that SJG provided. The amounts shown exclude other charges that are directly assigned or otherwise billed by SJI to affiliates using other means).

Table IV-2. Charges from SJI to Other Subsidiaries

	10/02-6/03	7/03-6/04	7/04-9/04
SJE			
Management Service Fee	72	83	21
Management Fee	33	91	30
Management Cost Allocation	1486	2065	563
Corporate & Fiscal	25	36	13
SJRG			
Management Service Fee	30	61	18
Management Cost Allocation	115	75	28
Corporate & Fiscal	17	27	11
Marina			
Management Service Fee	20	53	15
Management Cost Allocation	44	148	39
Corporate & Fiscal	10	23	9
SJG			
Management Service Fee	1245	1954	438
Management Cost Allocation	402	1054	293
Corporate & Fiscal	600	807	258
*Appliance Service Business**			
Management Service Fee	49	86	13
Management Cost Allocation	43	58	6

Corporate & Fiscal	23	36	7
Energy Service Plus			
Management Service Fee			8
Management Cost Allocation	2	24	13
Corporate & Fiscal			5
RTG			
Management Cost Allocation	2	2	1
Energy & Minerals			
Management Service Fee	0	0	0
Management Cost Allocation	2	2	1
Corporate & Fiscal	0	0	0
Grand total - Management Service Fee	1416	2237	513
Grand total - Management Cost Allocation	2097	3429	945
Grand total – Corporate & Fiscal	675	929	303

Thousands of dollars; Appliance-Service Business amounts taken from billings to SJG

The charges for the third quarter of 2004 are consistent with the 12-month period immediately preceding it. The following table shows how much of its costs, SJI then redistributes to SJG.

Table IV-3. SJG's Responsibility SJI Costs

	10/02-6/03	7/03-6/04	7/04-9/04
Management Service Fee	87.9%	87.4%	85.4%
Management Cost Allocation	19.2%	30.7%	31.0%
Corporate & Fiscal	88.9%	86.9%	85.2%

This table shows what would be expected, which is that SJG accounts for the lion's share of the distribution of costs through the *Management Service Fee* and the *Corporate and Fiscal Expense* allocators, followed by the appliance-service business, SJE, SJRG, and Marina.

SJG also performs services for SJI. The following table shows Liberty's summary of SJG's charges to its affiliates.

Table IV-4. SJG Time Allocation-Management Cost

	10/02-6/03	7/03-6/04	7/04-9/04
Millennium	3	1	0
SJRG	24	57	13
Marina	12	60	21
SJI	600	747	164
R&T	3	2	1
SJ Fuel	7	4	3
SJE	113	109	16
SJ Enertrade	3	2	0
Energy & Minerals	18	19	1
ASB		41	43
TOTAL	783	1042	262

This analysis shows a result that is not surprising, which is that SJI receives more charges than any other SJG affiliate, mostly because SJG employees are in effect part-time employees of SJI. To some extent, SJG is able to defray a part of its operating costs by performing services for other SJI companies.

Liberty considered two different periods in examining the hours spent by management people in service functions: September 2004 only, and the entire two-year audit period. September 2004 is a useful period because it was the most recent month available as field work proceeded, and the last month of the audit period. Liberty's analysis of this one month was more detailed than the analysis of the 24-month audit period. The two years of data for the audit period are a more reliable indicator of long-term trends, but the large amount of data makes it impractical to analyze in the same detail as can be done for one month.

<u>September 2004</u>

The month of September 2004 included 176 workable hours, based on its number of work days. The following table shows the distribution of SJI employee work hours in that month.

Table IV-5. SJI Employee Work Hours

Entity	Hours Billed
SJI (parent)	887
Millennium	8
Other SJI	680
SJG	1,615
SJE	3,805
SJRG	22
Marina	380
SJESP	108
Discontinued Ops.	25
Total	7,736

For September 2004

The *SJI Other* category comprises time not spent on general corporate matters, which means that SJI does not allocated to other subsidiaries. Liberty made the following observations from its review of the time charged by SJI's employees:

- SJI's CEO assigned 70 hours of his time to SJI, and the remaining 106 to SJG, which appeared reasonable.
- SJI's vice president of marketing, and the head of SJE, assigned half his time to SJE and Marina and half to SJI Corporate. The Financial Planning function, made up of four people, assigned half of its time to SJG and the other half to SJI. This amount appeared reasonable.
- The Accounting department was made up of 5 people, who worked a total of 880 hours, the distribution of which was 8 hours to Millennium Account Services, 239 to SJI Corporate, 96 to SJI Other, 69 to SJG, 259 to SJE, 119 to SJRG, 35 to Marina, 30 to SJESP, and 25 to discontinued operations. The employee responsible for risk management assigned his time in the following manner: 39 hours to SJI Corporate 16 to

SJI Other, 8 to SJG, 39 to SJE, 67 to SJRG, and 7 to Marina. This distribution appeared reasonable.

- The employee responsible for AirLogics had all of his time assigned to AirLogics.
- The Energy Service & Sales department appropriately assigned no time to SJG or to SJI Corporate.
- Government Relations, which consists of 1 person, assigned 40 hours to SJI Corporate, and 16 to SJI Other, and the remaining 120 hours to SJG, which appears reasonable.
- Internal Auditing (4 people who worked 704 hours) assigned 112 hours to SJ1 Corporate and 51 to SJI Other, 428 hours to SJG, 4 hours to SJE, and 109 hours to SJRG. This distribution appears reasonable.
- The Marina employees on SJI's payroll assigned their time only to Marina.
- The marketing department of five people (880 workable hours) assigned 37 hours to SJI Corporate and 60 to SJI Other, 77 hours to SJESP, 252 hours to SJE, and 454 hours to SJG. In light of the relative size of these companies and how the marketing department supports them, this distribution appears to be reasonable.
- SJE has 10 people, which equates to 1,760 hours for the month. Of that time 48 hours was assigned to SJI Corporate and 172 hours to SJI Other, 16 hours to Marina, and the balance of 1,524 to SJE. This assignment of time meant that SJG would bear less than 40 hours of time through later distribution of SJI's charges.

The following table shows the distributing of SJG employee September 2004 time.

Table IV-6. SJG Employee Work Hours

Entity	Hours Billed
SJI (parent)	691.07
Millennium	20.25
Other SJI	34.00
SJG	10,033.75
SJE	58.60
SJRG	112.25
Marina	90.00
SJESP	368.58
Discontinued Ops.	31.50
Total	11,439.00

For September 2004

Liberty found that, with the exceptions of SJG's counsel and its CFO, and of SJI's treasurer (who in this month charged no time to SJG), most SJG executives charged the great majority of their time to SJG. The results that Liberty observed generally appear to be appropriate. The analysis that follows on the two-year period treats the counsel and CFO in detail.

Liberty formed the following observations from its review of the assignments of SJG employees' September 2004 time:

- The CCC has eight management people who charged a total of 23.5 hours to SJESP, which appears to be reasonable.
- Environmental Affairs charged all of its time to SJG or SJG's MGP account.
- HR has four people who charged 704 hrs, 9.5 of which went to SJI Corp, 12.25 to MAS, 612.2 hours to SJG, and 70.05 hours to SJESP. This distribution appears to be reasonable.
- The Insurance department has two people (356 hours) who charged 24 hours to SJI Corporate, 165 hours to SJG, 7.5 hours to SJE, 91 hours to SJRG, 21.5 hours to Marina, 20.5 hours to SJESP, and 26.5 hours to discontinued operations. This wide dispersion of time is indicative of attention to detail in time reporting.
- The Accounting & Taxes department had 12 people and 2,108 billable hours, of which 1684.9 hours were assigned to SJG, 189.82 hours to SJI Corporate, 4 hours to MAS, 7 hours to Corp Other, 0.5 to MAS Reimbursement, 20 hours to SJE, 4.5 hours to SJRG, 7.5 hours to Marina, 177.78 hours to SJESP, and 5 hours to discontinued operations. Given that there is an SJI accounting function, this division of time among companies appears to be reasonable.
- Cash Management has one person, who assigned 5.5 hours to SJI Corporate, 160.25 hours to SJG, 5.25 hours to SJE, 3.75 hours to SJRG, 0.25 hours to Marina Energy, and 1 hour to SJESP. This distribution appears to be appropriate.
- SJG's Materials Management department assigned 840.5 hours out of a possible 872 hours to SJG, and 12.5 hours to SJI Corp, 2.75 hours to SJE, 3 hours to Marina, and 13.25 hours to SJESP. This distribution appears reasonable.
- Facilities/Building Services had five people with 908 billable hours, who assigned SJG 850 of those hours, with the balance going to SJI Corporate, SJE, and SJESP. This distribution appears to be reasonable.
- Communications had five people, who billed most of their time to SJG (763.75 hours), with the balance of 43.75 hours to SJI Corporate, 4 hours to SJE, 8 hours to SJRG, 7.75 hours to Marina, and 31.75 hours to SJESP. This distribution appears to be reasonable.

<u>2-Year Audit Period</u>

Liberty's analysis of the distribution of hours of SJG and SJI management personnel during the 2-year audit period consisted of three parts:

- The trend of time distribution by the CFO and corporate counsel
- Sample tests of time distribution by other key executives
- Broad review of the distribution of time by SJG and SJI to their affiliates.

The following table summarizes the distribution of time by the CFO and the corporate counsel. The full titles of these two officers are:

- CFO: SJI Vice President & CFO; SJG Executive Vice President & CFO
- Corporate Counsel: SJI Vice President, Corporate Counsel & Corporate Secretary ; SJG Senior Vice President, Corporate Counsel & Corporate Secretary

Table IV-7. CFO and Corporate Counsel Time Distribution

	2002	**2003**	**2004** (8 months)

	SJG	SJI	Others	SJG	SJI	Others	SJG	SJI	Others
CFO	90.6	8.2	1.1	83.6	14.2	2.2	79.7	18.5	1.9
Counsel	42.2	26.5	31.2	46.5	39.8	13.5	50.3	42.0	7.5

These data show that the assignment of the CFO's time directly to SJG has decreased substantially since 2002. The change, however, does not mean that SJG's share of his costs has dropped by an equivalent amount. The reason is that most of his reassigned hours moved to SJI, which then assigns most of its time and costs to SJG. The assignment of the time of the corporate counsel has shown an increase in the assignment of time to SJG and SJI and a large decrease in time assigned to other subsidiaries. He did assign 13.3 percent of his 2002 time to Marina, 10.8 percent to SJE, and 5 percent to SJRG, when these companies were collectively at earlier stages of development. Nonetheless, by 2004 these two executives, who have joint appointments with the utility and its parent, assigned relatively little of their time to the holding company that owns non-utility companies. In addition to the need to do direct work, executives like these have ministerial roles for the subsidiaries. For example, the corporate counsel of SJI/SJG also serves as general counsel and secretary to SJRG, yet he billed only 7 hours of his time to that company during the first eight months of 2004.

Liberty made the following observations on the distribution of time of other key executives in SJG and SJI during the audit period.

CEO: SJI's current CEO became executive vice president and chief operating officer in January 2002, president & chief operating officer in January 2003, and CEO in February 2004:

- Through the last quarter of 2002 none of his time was directly charged to SJG
- In 2003 SJG bore 141 hours of his January time, 114 in February, 92 in March, 100 in April and May, 90 in June, 130 in July, 78 in August, 84 in September, 114 in October, and 122 in November and December
- The experience in 2004 was similar
- While it is true that SJG is SJI's most important subsidiary, it is also true that SJG has a full complement of officers, and the other active subsidiaries were likely to have needed substantial attention then, compared to a stable business like SJG.

Chairman of the Board: SJI's former CEO and current chairman served SJI's president and CEO until January 2003.

- In October 2002, he charged 106 hours of his time to SJG, and he charged 78 and 79 hours to SJG in November and December, respectively.
- In 2003, his monthly charges to SJG were steady, and averaged 86 hours, or about half time.
- The pattern extended to January 2004, his last month as an employee.
- This distribution of time seems appropriate given SJG's importance to SJI.

Gas Supply: The officer responsible for SGJ gas supply and off-system sales also served through 2003 SJRG:

- He charged 43 hours of his time to SJRG in Oct 2002, and 46 hours total for November and December.
- In 2003 his level of time charges to SJRG declined, and averaged only 24 hours per month.
- The level of charges by SJI and SJG officers to SJRG appears to be low in light of that subsidiary's level and type of activity.

Information Systems: The vice president in charge of IS is an SJG employee:

- He charged all of his time to SJG only in the last quarter of 2002 and just 2 hours outside of SJG in 2003
- For the first three quarters of 2004 he reported only 5 hours of time to SJI subsidiaries other than SJG
- The IS department supports SJI's corporate functions and the other SJI subsidiaries, albeit sometimes in a limited way
- The service agreement between SJG's Information Systems department and SJESP, however, says that this officer "will act as the 'Strategic IS Business Partner'" to SJESP and "will provide consulting services and help develop the IT strategy for" SJESP; similar language is included in other service agreements.
- The current level of time reporting to companies other than SJG appears to be inadequate.

Controller: SJG's controller, an SJG employee is also SJI's director, general accounting and taxes:

- He charged 26 hours per month to companies other than SJG in the last quarter of 2002
- In 2003 and 2004 this officer charged an average of 12 hours per month to companies other than SJG
- In light of the fact that SJG's controller is SJI's and SJG's leader in setting policies for the distribution of costs between SJI companies, this low level of charges to companies other than SJG does not appear to be sufficient.

Treasurer: SJI's treasurer is an SJG employee. He assumed that position in 2004 and before that was director of investor relations and finance.

- He charged 64 hours to SJG in the last quarter of 2002
- In 2003 his average monthly charges to SJG were 55 hours, and fell to an average of 16 hours per month in the first three quarters of 2004
- In light of this officer's responsibility for the holding company and all of its subsidiaries, but also noting that SJG is the largest user of capital among the subsidiaries, this level of charging to entities other than SJG appears to be reasonable.

The following tables display Liberty's summary of the assignment of hours by SJI and SJG to their affiliates resulted in these two charts.

Table IV-8. Hours Billed by SJI

	SJI Corp	SJI MAS	SJI Other	SJG	SJG ASB	SJE	SJRG	Marina	SJESP	Discon-tinued	Total
Oct-02	845.00		76.00	867.50	82.50	1,950.00	82.00	122.00		23.00	4,048.00
Nov-02	839.00		50.00	663.50	62.00	1,866.50	83.00	104.00		12.00	3,680.00
Dec-02	1,140.00		132.00	702.00	81.00	1,465.50	78.00	92.00		13.00	3,703.50
Total	*2,824.00*		*258.00*	*2,233.00*	*225.50*	*5,282.00*	*243.00*	*318.00*		*48.00*	*11,431.50*
Mean	*941.33*		*86.00*	*744.33*	*75.17*	*1,760.67*	*81.00*	*106.00*		*16.00*	*3,810.50*
Jan-03	1,159.50		84.00	675.00	116.00	3,123.50	69.00	141.00		88.00	5,456.00
Feb-03	943.00		52.00	759.50	135.50	3,227.00	115.00	155.00		69.00	5,456.00
Mar-03	722.50		68.00	726.00	112.00	3,114.50	116.00	184.00		68.00	5,111.00
Apr-03	1,053.50		78.00	688.50	122.50	3,383.50	101.00	206.00		55.00	5,688.00
May-03	691.50		60.00	826.00	126.00	3,052.00	107.00	198.00		27.50	5,088.00
Jun-03	1,102.00	1.00	92.00	1,157.00	105.00	3,520.00	118.00	222.00	51.00	16.00	6,384.00
Jul-03	1,288.00		58.00	1,303.00	168.50	3,166.50	122.00	195.00	19.00	17.00	6,337.00
Aug-03	984.00		102.00	1,274.50	167.50	3,208.00	80.00	142.00	27.00	9.00	5,994.00
Sep-03	1,039.50		112.00	1,183.50	206.00	3,819.00	137.00	222.00	14.00	9.00	6,742.00
Oct-03	1,164.00		56.00	1,418.00	124.00	3,537.00	106.00	197.00	38.00	16.00	6,656.00
Nov-03	1,219.00		62.00	1,426.00	132.00	3,524.00	94.00	208.00	17.00	6.00	6,688.00
Dec-03	1,733.00		78.00	1,299.00	91.00	3,290.00	103.00	186.00	101.00	9.00	6,890.00
Total	*13,099.50*	*1.00*	*902.00*	*12,736.00*	*1,606.00*	*39,965.00*	*1,268.00*	*2,256.00*	*267.00*	*389.50*	*72,490.00*
Mean	*1,091.63*		*75.17*	*1,061.33*	*133.83*	*3,330.42*	*105.67*	*188.00*	*38.14*	*32.46*	*6,040.83*
Jan-04	1,329.00		442.00	1,298.00	56.00	3,296.00	105.00	174.00	83.00	13.00	6,796.00
Feb-04	1,517.00		526.00	1,552.00	94.00	3,677.00	93.00	218.00	21.00	12.00	7,710.00
Mar-04	787.50		360.00	1,674.00	18.00	3,861.50	95.00	263.00	81.00	7.00	7,147.00
Apr-04	966.50		446.00	1,946.00	124.00	3,703.50	102.75	220.25	19.00	15.00	7,543.00
May-04	935.00		356.00	1,937.50	94.00	4,173.00	143.00	295.00	50.00	14.00	7,997.50
Jun-04	889.00		612.00	1,758.00	35.00	4,308.00	219.00	360.00	88.00	11.00	8,280.00
Jul-04	801.00		821.00	1,200.00	134.00	3,507.50	106.00	366.00	35.00	18.00	6,988.50
Aug-04	968.00		408.50	1,950.00	16.00	3,985.50	163.00	403.00	168.00	14.00	8,076.00
Sep-04	887.00	8.00	680.00	1,615.00		3,805.00	228.00	380.00	108.00	25.00	7,736.00
Total	*9,080.00*	*8.00*	*4,651.50*	*14,930.50*	*571.00*	*34,317.00*	*1,254.75*	*2,679.25*	*653.00*	*129.00*	*68,274.00*
Mean	*1,008.89*		*516.83*	*1,658.94*	*71.38*	*3,813.00*	*139.42*	*297.69*	*72.56*	*14.33*	*7,586.00*

Note: MAS is Millennium Account Services.

Table IV-9. Hours Billed by SJG

	SJI Corp	SJI MAS	SJI Other	SJG	SJG ASB	MAS*	SJE	SJRG	Marina	SJESP	Discon-tinued	Total
Oct-02	897.67	3.50		11,393.68	214.63	2.50	425.52	109.50	55.50		81.50	13,184.00
Nov-02	1,003.10	14.50	0.25	11,113.17	199.38	2.50	121.36	85.25	49.25		47.25	12,636.01
Dec-02	690.17	12.67		11,332.76	162.88	3.50	296.02	106.75	49.00		51.25	12,705.00
Total	*2,590.94*	*30.67*	*0.25*	*33,839.61*	*576.89*	*8.50*	*842.90*	*301.50*		*0.00*	*180.00*	*38,525.01*
Mean	*863.65*	*10.22*	*0.25*	*11,279.87*	*192.30*	*2.83*	*280.97*	*100.50*	*51.25*		*60.00*	*12,841.67*
Jan-03	824.40	25.50	4.00	11,586.43	351.92	0.50	261.00	79.75	74.50		64.00	13,272.00
Feb-03	924.40	24.25		11,359.68	415.42	2.50	120.00	103.00	42.00		64.25	13,055.50
Mar-03	597.80	10.25		10,026.12	410.15	4.00	245.50	85.50	50.50		88.00	11,517.82
Apr-03	797.86	4.00	30.00	12,082.03	342.35	3.50	192.25	84.25	36.50		33.75	13,606.49
May-03	845.48	10.75		11,179.62	337.65	24.50	149.25	71.00	68.50	4.00	53.00	12,743.75

Jun-03	792.86	20.75		12,408.28	279.85	26.25	172.50	85.50	98.50	27.00	69.00	13,980.49
Jul-03	678.40	14.75		11,075.23	301.37	0.50	157.50	106.00	105.50	8.75	28.50	12,476.50
Aug-03	637.99	2.25		11,121.12	284.64	3.50	144.75	86.50	83.00	52.25	17.00	12,433.00
Sep-03	824.61	9.50	19.25	11,808.28	276.60	0.50	212.00	107.00	29.00	42.75	56.50	13,385.99
Oct-03	793.69	28.00		10,487.89	248.16	0.50	189.75	109.00	46.75	13.25	29.00	11,945.99
Nov-03	741.15	6.25		10,618.51	230.59	0.50	166.00	108.00	69.50	5.00	47.00	11,992.50
Dec-03	653.90	12.83		10,878.45	263.37	0.50	160.25	154.50	147.50	2.00	39.20	12,312.50
Total	*9,112.54*	*169.08*	*53.25*	*134,631.6*	*3,742.07*	*67.25*	*2,170.75*	*1,180.00*	*851.75*	*155.00*	*589.20*	*152,722.5*
Mean	*759.38*	*14.09*	*17.75*	*11,219.30*	*311.84*	*5.60*	*180.90*	*98.33*	*70.98*	*19.38*	*49.10*	*12,726.88*
Jan-04	804.35	8.33		9,917.48	230.59	0.50	125.50	86.00	42.00	19.25	22.00	11,256.00
Feb-04	917.44	5.33	1.00	10,696.64	261.64	1.25	285.75	75.75	80.25	14.00	32.95	12,372.00
Mar-04	558.60	2.33		9,910.48	295.84	0.50	-57.00	64.00	66.25	7.00	40.00	10,888.00
Apr-04	821.18	9.33	54.00	9,320.85	242.09	0.50	91.50	59.00	91.25	11.50	37.80	10,739.00
May-04	770.35	13.83	34.00	9,618.26	245.42	0.50	142.25	104.50	95.50	41.75	52.40	11,118.76
Jun-04	684.19	32.20	8.00	10,292.47	264.39	0.50	75.75	83.00	85.75	71.00	56.00	11,653.25
Jul-04	503.68	10.33	60.25	9,126.18	227.06		52.75	71.50	83.25	57.50	74.00	10,266.50
Aug-04	721.69	17.45	33.00	10,804.97	293.29	1.00	94.75	103.00	84.00	102.75	84.10	12,340.00
Sep-04	691.07	20.25	34.00	10,033.24		0.50	58.60	111.25	90.00	368.58	31.50	11,438.99
Total	*6,472.55*	*119.38*	*224.25*	*89,720.57*	*2,060.32*	*5.25*	*869.85*	*758.00*	*718.25*	*693.33*	*430.75*	*102,072.5*
Mean	*719.17*	*13.26*	*32.04*	*9,968.95*	*257.54*	*0.66*	*96.65*	*84.22*	*79.81*	*77.04*	*47.86*	*11,341.39*

Note: MAS (Millennium Account Services) entries are for "Reimbursement" for time spent on Millennium that is billed to Millennium and borne by no other subsidiary.

Liberty made the following observations about the distribution of hours by SJI and SJG to other subsidiaries.

Millennium:

- The charges by SJI employees to MAS were so small as to be irrelevant.
- The charges by SJG employees to MAS in the fourth quarter of 2002 were close to zero.
- However, the total charges in 2003 and the first three quarters of 2004 were about 288 hours, or the equivalent of about seven person-weeks of time, which appears to be more representative of the attention this 50-percent joint venture might require.

SJI to SJG:

- The direct assignment of the time of SJI's personnel to SJG, excluding the appliance-service business, shows a doubling of the mean monthly time from the fourth quarter of 2002 to 2004.
- In some months in 2004 the time charged to SJG by SJI employees was about three times that of the lowest monthly charges in 2002.
- During the two-year period the number of SJI employees increased from 26 to 46, of which seven were formerly SJG employees; function transfers accounted for much of this change.
- The charges by SJG employees to SJG dropped more than the increase in charges by SJI employees to SJG from 2004 to 2003.

- Therefore, the total hours charged to SJG from the two entities combined decreased on a net basis; this is a favorable development.

SJE

- The increase in charges from SJI to SJE—because SJI's staff includes SJE's employees—accounts for more than half of the increase in SJI's total hours between the end of 2002 and 2004.
- Charges from SJG employees to SJE decreased during the period, but not enough to account for the increase by SJI employees.

SJI Corporate

- The average of charges by SJI employees to SJI corporate stayed generally steady during the two-year period.
- There was large variation during the 24 months.
- Charges to *SJI Other* increased almost five-fold in 2004 from their highest level in 2003
- *SJI Other* includes costs not for general corporate needs; time charged to this category does not get distributed to the other subsidiaries.
- The level of charges from SJG employees to SJI decreased slightly over the 2-year period, which was not enough to account for the increase in charges from SJI employees to SJI.

Marina

- The charges to Marina from SJI increased steadily over the two-year period, as its largest project (Borgata) was coming on line, and even after the project started.
- This trend appears to be appropriate, although it is not possible to judge whether the absolute level of charges is what they should be, even at an average in 2004 of the equivalent of more than seven person-weeks per month, because other SJI employees were likely to have been involved in some of the major decisions that were made.

Appliance-Service Business and SJESP

- The level of charging by SJI employees to SJG's ASB operation remained reasonably steady until it was spun off as SJESP.
- That level of charging, however, was not high.
- In addition, as Liberty has noted elsewhere in this report, the level of charges to SJESP by both SJI and SJG employees was low while the new company was only in the installation business and was preparing to take over SJG's ASB operation.
- When SJESP actually started in the service portion of the business, the level of charges increased substantially, both for SJI and also for charges from SJG employees.
- It is the low level of charges leading up to the move of SJG's ASB to SJESP that raises a question of adequacy of charges.
- The charges to ASB did rise in 2003 from the last quarter of 2002 during preparations for the spin-off.

Discontinued Operations

- These operations bore a reasonably steady level of direct charges from both SJI and SJG during the two-year period.
- Some peaks that would indicate that some special work was done.
- That the charges were not flat indicates that the people who assigned time to these operations were cognizant of the need to report their time to the companies for whom they were working.

SJRG

- The hours charged to SJRG by employees of SJG decreased slightly over the period and the charging by SJI employees increased slightly.
- However, the total of SJI's and SJG's charges to SJRG stayed constant, at an average of about 200 hours per month.
- This level of charging appears to be low in light of SJRG's importance to SJI (9 percent of SJI's net income) and the volume and complexity of it business, including the difference of accounting for the subsidiary compared with the others.

C. Conclusions

a. Management reporting and analysis of the distribution of costs between companies is insufficient, and the resources devoted to managing the distribution of costs are small.

SJI, with about 70 employees who are on its payroll, comprises a small organization. The complexity of its cost structure, however, belies its small size. SJI provides a mixture of corporate functions to all entities, SJG included, and serves as the principal employer for SJI's non-utility companies. Further complicating the situation is the fact that SJI does not house all of the corporate functions, but instead shares some of SJG's people to perform a number of those functions. These circumstances make straightforward analysis of the budgets and actual expenditures of SJI and its parts complicated. The relevant numbers include the *Corporate & Fiscal Expense* allocator, the *Management Service Fee*, the billings from SJG to SJI and re-billings to SJG, and charges between SJG and SJI when they buy certain services on behalf of each other. SJI and SJG accounting personnel may understand these relationships, but the situation does not lend itself to clear and useful reporting and analysis for non-financial managers. The new Lawson-system tools begin developed should bring improvement in the usefulness of information for conducting SJG's business.

Liberty expected to be able readily to examine the budgeted and actual amounts of the various charges that SJI made to its subsidiary companies. However, there is no regular management reporting of those charges against, for example, budgeted amounts. Too much of Liberty's audit analysis and the presentation of that analysis in this report were of raw data, and not usefully categorized information.

The Lawson system that SJG now uses *cost centers,* but the SJI/SJG accounting function has not had the time to set up standard reports. They cited this audit, the requirements of complying with section 404 of the Sarbanes-Oxley Act, and some staffing problems as reasons for delay. Thus, the kinds of reporting that managers outside of the accounting functions could use to evaluate the costs that they receive and charge others are not yet available. In addition, the auditability of these costs by entities outside the companies will remain constrained until that delay has been overcome.

Liberty did observe that, in the last part of 2004, the SJI/SJG accounting functions started to provide a monthly summary of timesheet information to every department head. The process of closing the books produces for SJG reports of the time of SJI employees. This new reporting, which in part stemmed from a Liberty request for data, represents a positive step in improving the management and control of affiliate costs. Another enhancement came in 2004; the monthly bill from SJI to SJG began to include an attachment that reports SJI billed hours. This change came as part of efforts to comply with Sarbanes-Oxley internal-control requirements.

Liberty found that SJI and SJG do place emphasis on trying properly to distribute costs among subsidiaries. The weakness that Liberty found insufficient resources being devoted to assuring that the methods used to meet regulatory requirements and provide department managers the kind of information that they need to start managing the transferring of costs. SJG needs to add an accounting person whose primary responsibility will be to examine affiliate relations and the distribution of costs.

In summary, Liberty found it necessary to devote much more time that should have been necessary to making useful the data that SJI and SJG made available. That said, however, upon completing its analyses, Liberty did not discover any major errors or biases.

b. The intercompany invoices do not have sufficient detail.

As discussed above, the results of intercompany charging and allocations of costs is not as transparent as it should be. While the bills do have detail, they do not provide a standalone explanation of what the costs are and why they have been incurred. An important example of this is that the monthly charges for the Corporate & Fiscal allocator and the *Management Service Fee* are line items on a bill. No accompanying data supports those charges.

c. The distribution of time does not raise significant questions.

D. Recommendations

11. Revamp and simplify the collection and reporting of inter-company charging.

The new modules of the Lawson system, including the project and activity accounting module, will give SJG and SJI the capability to enhance the management reporting and analysis of how they distribute costs among cost centers within companies. In addition, the companies can take advantage of the system's features to increase the accuracy and transparency of the affiliate billing processes. SJI does not use the Lawson system, but it should, in order to assure that all important affiliate reporting and billing is automated, consistent, and comprehensive.

The flexibility of the Lawson system will also permit the use of overhead riders, and enable SJG to redistribute other kinds of general and administrative costs; *e.g.*, subscriptions, which SJG's tax accounting department currently absorbs.

In undertaking this effort, SJI/SJG should be aiming at improving the auditability and reporting of costs to managers. Those managers should be monitoring the charges distributed to their cost centers. The reporting of costs should be readily understandable by non-accountants. Every cost center should be able to see who has been charging to each cost center's sub-accounts. This reporting should comparisons of budgeted and actual costs by cost center of the serving entity.

Another objective should be to assure that the intercompany bills with back-up are auditable on a standalone basis; *i.e.*, without the need to check other documentation.

Finally, as this effort is undertaken the *Corporate and Fiscal Expense* and *Management Service Fee* can be combined, which will further serve to simplify the work of the accounting function and of management employees who have to understand the results.

12. Devote a full-time equivalent person to assuring that the tasks of distributing costs among affiliates are done in a timely manner.

Without the application of more effort, the ability to accomplish needed tasks with reasonable dispatch is unlikely. The investment in a better financial system has occurred; it makes sense to get the return on that investment sooner, rather than deferring it. Until the changes recommended in this report are made, which will take significant effort, SJG will not have made all the improvements necessary to assure that it is using the fully-allocated costs necessary to prevent cross-subsidization.

Because SJG's customers did not cause SJI to enter non-utility businesses the cost of this and other compliance with EDECA and other requirements to avoid the cross-subsidization of non-utility businesses by utility operations should be borne entirely by SJI and its non-utility subsidiaries and not re-billed to SJG.

The added resources need not be in the person of a single individual. A number of individuals could collectively perform the required work through part-time assignments, provided that their time is dedicated to such work. Liberty estimates that the total time requirements should approximate one-full time equivalent person, more or less.